BOSTON EDISON COMPANY
CAMBRIDGE ELECTRIC LIGHT COMPANY
COMMONWEALTH ELECTRIC COMPANY
NSTAR GAS COMPANY

Direct Testimony of James J. Judge

Exhibit NSTAR-JJJ

D.T.E. 03-__

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is James J. Judge. My business address is 800 Boylston Street, Boston, Massachusetts, 02199.

Q. By whom are you employed, and in what capacity?

A. I am Senior Vice President, Treasurer and Chief Financial Officer of NSTAR and each of its four regulated distribution companies, Boston Edison Company ("Boston Edison"), Cambridge Electric Light Company ("Cambridge"), Commonwealth Electric Company ("Commonwealth") and NSTAR Gas Company ("NSTAR Gas") (collectively, "NSTAR" or the "Company").

Q. Please describe other positions you have held at Boston Edison and your professional qualifications.

A. Since its creation in 1999, I have served as the Senior Vice President and Treasurer of NSTAR. I served as Senior Vice President and Treasurer of Boston Edison beginning in 1995. I have also served in a number of other positions within Boston Edison, including, Director of Corporate Planning and Assistant Treasurer, Assistant Treasurer, Manager of Financial Planning and Senior Financial Analyst. I joined Boston Edison in 1977 and I hold Bachelor of Science and a Masters degree in Business Administration from Babson College.

Q. Have you previously testified before the Department of Telecommunications and Energy?

A. Yes. I have testified in a number of proceedings before, the Department of Telecommunications and Energy's (the "Department") including the Department's review of the rate plan filed in conjunction with the merger of BEC Energy and Commonwealth Energy System ("COM/Energy") in D.T.E. 99-19, which led to the formation of NSTAR.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to describe NSTAR's tariff proposal to establish a reconciliation adjustment mechanism for the recovery of costs associated with the Company's obligations to provide pension benefits and post-retirement benefits other than pensions ("PBOPs") to its employees. The Company is proposing a pension/PBOP-expense reconciliation mechanism that is designed to give effect to the accounting treatment approved by the Department in D.T.E. 02-78. According to the Company's auditors, this filing is required in order to avoid a charge against equity and negative earnings impacts. The Company's proposal is intended to present a reasonable and workable ratemaking mechanism that will provide for the recovery of pension and PBOP costs that are incurred by the Company in providing service to customers. The reconciliation mechanism will bring into balance disparities between the amount of pension and PBOP costs being collected in rates with the Company's reported pension and PBOP expenses, and eliminate over time any prefunded or underfunded balances that result from the Company's cash contributions to the funds. Because the Company's funding obligations and expenses have become extremely volatile as a result of accounting requirements and events external to the Company, pension and PBOP expenses are no longer susceptible to the Department's traditional ratemaking process of including a representative amount in rates. The Company's proposed reconciling mechanism will provide future rate stability and ensure that customers pay no more and no less than the amounts needed to provide pension and PBOP benefits for the Company's employees. In addition, this mechanism will ensure that the financial integrity of the Company is not impaired by the financial reporting requirements and cash-flow issues that arise from the extreme volatility of pension and PBOP funding obligations.

The remainder of the testimony is composed of four sections: (1) a description of the NSTAR pension and PBOP plans; (2) a description of the accounting requirements associated with the plans; (3) a review of how the Department has treated, for ratemaking purposes, expenditures made by regulated utilities relating to pension and PBOP plans; and (4) a description and support for NSTAR's tariff and ratemaking proposal to establish a reconciling mechanism for costs associated with the pension and PBOP plans.

III. BACKGROUND OF PENSION/PBOP PLANS

Q. Please describe the NSTAR pension and other post-retirement benefit plans.

A NSTAR sponsors the NSTAR Pension Plan, a defined benefit pension plan that covers approximately 3,300 employees and 4,000 retirees and their beneficiaries. The pension plan was adopted effective January 1, 2000 following the corporate merger of BEC Energy and COM/Energy into NSTAR, and is the result of the consolidation of those two predecessor companies. The NSTAR Pension Plan was established to provide retirement benefits for employees. The Pension Plan includes several benefit formulas that are dependent upon an employee's union affiliation or non-represented status. The Pension Plan maintains a trust fund, which holds assets available to fund plan benefits for current and future participants of the Pension Plan.

In addition, the Company provides post-retirement health and life-insurance benefits to its retirees under the Group Welfare Benefits Plan For Retirees of NSTAR (the "PBOP Plan"). This PBOP Plan provides benefits to retirees and their dependents upon separation of employment under various programs. The PBOP Plan maintains several Voluntary Employee Benefit Trusts ("VEBA") to fund covered benefits.

Q. Why does the Company provide these benefits?

A. NSTAR and its bargaining units have negotiated the pension benefits for represented employees through the collective-bargaining process. NSTAR also offers non-represented participants a defined benefit pension plan as part of a comprehensive total compensation package. In addition, the Company provides certain health and life-insurance benefits to employees who leave the Company and who meet certain criteria upon separation from employment. Defined benefit pension plans and post-retirement health and life-insurance benefits are typical benefits offerings in the utility industry.

Q. Please describe the pension plans available to the various NSTAR employee groups.

A. NSTAR's union employees are represented by two union locals: Local 369 of the Utility Workers Union of America and AFL-CIO, and Local 12004 of the United Steelworkers of America. The Union Local 369 pension benefit is a final average-pay benefit for the highest consecutive 36 months average base pay of the last 10 years. Normal retirement benefits are available at age 65 and there are various early retirement options. There are several payment options available to participants including life annuities, various survivor annuities, and lump-sum distributions for some participants. Effective January 2001, Union Local 369 had absorbed former COM/Energy Union Locals 333, 338 339 and 392 and former Boston Edison Union Local 387. Each of these former bargaining units had their own pension formulae that will change to the Local 369 benefit formula over time.

The Union Local 12004 benefit is a final average-pay benefit based on the highest consecutive January 1 base rate of pay over the last 10 years. Normal retirement benefits are available at age 65 and there are various early retirement options. There are several payment options available to participants including life annuities and various survivor annuities.

Non-represented employees participate in a Pension Equity Plan, which is a hybrid form of defined benefit plan based on the highest three years of pay at July 1 in the last 10 years. The benefit under this plan is defined as a single lump-sum payment amount available at termination. Various annuity options are also available to participants.

Any represented or non-represented employee with five or more years of service is fully vested and entitled to pension benefits following the end of his or her employment with NSTAR. Please refer the Exhibit NSTAR-JJJ-1, the Summary Plan Descriptions, for more detailed explanations of the NSTAR Pension Plan.

Q. Please describe the post-retirement health plans available to the various NSTAR employee groups.

A. NSTAR's retiring employees are eligible for health and life-insurance benefits upon termination of employment. Pre-65 retirees have a choice of a Preferred

Provider Organization or two Health Maintenance Organizations. Post-65 retirees have a choice of Medex II or three Medicare Risk Health Maintenance Organizations. Represented employees are also eligible for dental coverage upon retirement. In addition, eligible employees have life-insurance coverage when they retire.

The participant cost for the health plans depends on the employee classification and are subject to various company contribution caps for some participants. Please refer to Exhibit NSTAR-JJJ-2 for the Summary Plan Descriptions of the NSTAR post-retirement benefits.

Q. What changes to the pension and PBOP plans have been made as a result of the merger?

A. As is indicated above, effective January 2001, Union Local 369 had absorbed five former Unions of COM/Energy and Boston Edison. Each of these former Unions had their own pension formulae, which will change to the Local 369 benefit formula over time. This will ultimately simplify pension plan administration for the consolidated groups. Effective January 1, 2000, the accrued pension benefits of the former COM/Energy and Boston Edison non-represented employees were converted to a beginning credit balance under the Pension Equity Plan. NSTAR converted to this new plan for the following reasons: (1) to standardize the pension for former COM/Energy and Boston Edison non-represented employees; (2) to provide a plan that would be an attractive recruiting tool and with more portability than a conventional defined benefit plan; and (3) to reduce the pension costs for employees hired after 1999. On the last point, the maximum participant value of this benefit for new hires is approximately 62 percent of that available to more tenured employees.

The Company has also made changes to its post-retirement health plans as the result of the merger. Effective April 1, 2003, NSTAR began to standardize the post-retirement benefits of existing retirees. NSTAR's measures to control costs in this area will result in significant cost savings. At the same time, retirees maintained important medical and prescription drug insurance coverages at levels the same as or comparable to current employees. Please refer the Exhibit NSTAR-JJJ-3, the Retiree Communication letter for more detailed explanations of the changes to the health plans for existing NSTAR retirees.

Q. What methods are used to assure that the funds are prudently invested and managed?

A. NSTAR employs a structured form of plan governance for the Pension Trust and Retirees Benefit Trusts, which follows the regulatory and prudence guidelines of the Employee Retirement Income Security Act ("ERISA"), the primary federal law that guides how plans are managed. Fund investment policy is approved and monitored by a committee of the Board of Trustees. The Pension Management Committee composed of financial, legal, and human resources executives recommends policy changes and reports fund performance to the Trustees. The

Pension Management Committee is supported by professional staff and various outside consultants including actuaries, attorneys, trustees, investment managers, and a pension investment consultant.

IV. BACKGROUND OF ACCOUNTING REQUIREMENTS FOR PENSION/PBOP PLANS

Q. Please generally describe how the Company computes its financial obligations for pensions and PBOPs under the Financial Accounting Standards Board ("FASB") requirements.

A. As described in more detail below, the determination of a company's pension and PBOP obligations (and corresponding FASB accounting treatment) starts with an actuarial study of the company's long-term obligations. Such studies are based on the actual covered employee and retiree population and projected trends in costs. Based on these judgments, a company's overall liability position is calculated. For instance, the age and work longevity of employees will have an impact on the timing and number of years they are likely to collect retirement benefits. The projected costs of health care will affect the costs needed to provide health benefits to retirees. In addition to the consideration of the projected obligations to employees and retirees, the actual trust asset balance must be considered in order to calculate the net funded status and the net expense of the plans. The expected long-term rate of return on the assets is calculated each year as an offset to the cost of the plan costs. Similarly, the funded status of the plan is affected by the actual trust fund balance. However, many of the FASB-required underlying assumptions and projections (especially with respect to future market returns and interest rates) can be very volatile and uncertain, and have significant impacts on the funded status of pension and PBOP plans for financial reporting purposes. These assumptions also drive the accounting that is required to reflect the funded status of a company's pension plan.

Q. Please describe the traditional accounting treatment prescribed by FASB that was used by the Company to account for its pension and PBOP benefits.

A. Prior to the issuance of Statement of Financial Accounting Standards ("SFAS") 87, accounting for pension plans varied greatly among companies. As a result, pension cost was not easily comparable from company to company. In addition, companies used a wide variety of measurement methods and assumptions in determining their pension obligations. This made the reporting of plan-funded status inconsistent.

Prior to the issuance of SFAS 106, most companies accounted for their PBOPs on a "pay as you go" basis. Under this method, medical and life-insurance benefits for retirees were expensed as they were provided, which was consistent with active employees.

Q. When did the FASB change this accounting treatment?

A. FASB issued SFAS 87, "Employers' Accounting for Pensions" in 1985, for effect as of January 1, 1987. FASB issued SFAS 106, "Employers' Accounting for

Postretirement Benefits Other Than Pensions" in 1990. SFAS 106 was effective as of January 1, 1993.

Q. Why did FASB change the generally accepted accounting treatment for these plans?

A. FASB's objective in issuing SFAS 87 and SFAS 106 was to establish a consistent and systematic method for recognizing future retirement benefit costs that were expected to accrue over the period of an employee's work life. In addition, FASB established requirements for companies to clearly disclose information about the funded status of their plans.

Q. Please describe the changes that were made by the FASB concerning pension and PBOP plans.

A. Both SFAS 87 and SFAS 106 were designed to require consistent measurement and recognition of pension and PBOP obligation and assets among reporting companies. Under SFAS 87 and SFAS 106, the costs to provide pension and PBOP benefits to employees are generally recognized during their working lives of employees, offset by the earnings on the funds that are set aside specifically to provide the funding for those benefits. Therefore, the basic principles of SFAS 87 and SFAS 106 are: (1) trust assets and plan obligations, as well as trust earnings and benefits earned, are netted for financial reporting purposes; and (2) the recognition of differences between accounting assumptions and actual plan experience are delayed and recognized over time.

Q. Please explain generally the tax treatment associated with pension and PBOP plans.

A. The Internal Revenue Service ("IRS") has established specific rules for the deductibility of contributions to trust funds of qualified pension plans and post-retirement benefit plans. The regular maximum pension contribution is based on normal cost, which is defined as the amount representing the portion of the cost of the participants' anticipated retirement allocated to the current plan year. Alternatively, a company is always able to deduct, as discussed below, an amount up to the unfunded current liability of the plan, which is the difference between the adjusted current liability of the plan at the end of the year as compared to the actuarial value of the assets at the end of the year.

Contributions to the VEBAs supporting other post-retirement benefit plans are more severely limited by IRS rules. Deductions for payments to fund post-retirement life-insurance and medical benefits are allowed to the extent that the contributions establish a reserve funded over the working lives of the covered employees. The contributions must be actuarially determined on a level basis using reasonable assumptions, with the exception that the assumption must be made that medical benefits will have the same cost in the future as they have today (i.e., no inflation adjustment is allowed). In this way, with the exception of an inflation adjustment, the medical and life-insurance benefits payable to a retired employee during retirement are fully funded upon retirement. The above rule does not apply to collectively bargained VEBAs. Contributions to these VEBAs are deductible in the year paid to the extent that the contribution does not exceed the actuarial liability for employees covered by the VEBA.

In addition, medical benefits for retirees are deductible when provided under the pension plan in what is referred to as a 401(h) account. The medical benefits, together with any life-insurance benefits provided under the pension plan, must be subordinate to the retirement benefits. To be subordinate, any contributions to a 401(h) account to provide medical or life-insurance benefits for retirees must not exceed 25 percent of the aggregate contributions to the pension plan, other than contributions to fund past service credits.

Q. What differences are there between tax deductibility and SFAS 87 accounting requirements?

A. The most significant difference between the IRS tax deduction rules and the FASB accounting rules involves the impact of the "funded status" of the plan on the calculation. The maximum tax-deductible contribution each year is based on the "unfunded current liability" as defined by the IRS. The maximum tax-deductible contribution for the year can be up to the unfunded current liability. Therefore, the decrease or increase in the funded position of the plan is immediately reflected in the IRS maximum contribution calculation. However, under the FASB accounting rules, the changes in plan liabilities and assets are always recognized through expense over time (i.e., they are amortized over an extended time period). This timing difference between the funded amount and the expense amount creates a prepaid (cumulative contributions greater than expense) or liability (cumulative expense greater than contributions) balance on a company's books.

Q. Please describe the current status of funding of the plans.

A. As of December 31, 2002, the pension and PBOP plans have the following asset and liability balances:

	Pension	PBOP
Accumulated benefit obligation	$844 million	$572 million
Asset value	$666 million	$215 million.

The accumulated benefit obligation ("ABO") is the actuarial present value of the total cost of pension and PBOP benefits attributed to service provided by employees to date without taking future compensation increases into account. As described below, an equity charge is required under SFAS 87 when the ABO exceeds the year-end asset value.

Q. In the Company's request for an accounting ruling in D.T.E. 02-78, you were granted approval to defer as a regulatory asset the Additional Minimum Liability. What is Additional Minimum Liability ("AML") and what is the magnitude of it for NSTAR?

A. Under SFAS 87, a company is required to compare the fair value of its plan assets and the amount of the ABO as of the end of each year. If the ABO exceeds the asset value, then there is what is referred to as an "unfunded ABO". The minimum pension liability balance that must be reflected on a company's books is the amount of the unfunded ABO. For NSTAR, its unfunded ABO as of December 31, 2002 was $178 million ($844 million ABO less $666 million of plan assets).

Q. How is the AML reflected on NSTAR's books?

A. When there is an unfunded ABO, SFAS 87 requires the recognition of an AML if the company's pension liability balance is lower than the unfunded ABO or if the company has a prepaid pension balance on its books. Since NSTAR has a prepaid pension balance on it books, the amount of the adjustment required to reflect the AML is the prepaid balance *plus* the unfunded ABO. NSTAR recorded a liability on it books of $178 million at year-end in 2002. This resulted in an AML adjustment of approximately $435 million ($178 million unfunded ABO plus $257 million prepaid pension balance). The $435 million adjustment was reflected on NSTAR's books as follows:

AML Regulatory asset	$168.8 million
Prepaid regulatory asset	257.0 million
Allocated to unregulated companies	7.9 million
Intangible asset	1.0 million
Total AML adjustment	$434.7 million

Q. What does the "Intangible Asset" represent?

A. Under SFAS 87, a company is permitted to recognize an intangible asset on its books as part of the AML adjustment to the extent that it has unrecognized transition obligation or unrecognized prior service losses. At December 31, 2002, this amount was $980,000 for NSTAR.

Q. Why did NSTAR request that the Department allow the recording of a regulatory asset on its books in relation to the AML?

A. SFAS 87 requires a company to take a charge to common equity net of taxes, through other comprehensive income, for the remaining AML after recognition of the intangible asset. The accounting order issued by the Department allowed the NSTAR companies to record a regulatory asset in lieu of a charge to equity to reflect the impact of the AML (after allocation to the unregulated companies).

Q. What factors have affected the current status of funding of the plans?

A. The funding status of the plans has been affected by the negative impact of both the investment performance of the plans' assets and the impact of declining interest rates on the liability balance.

Q. Have funding levels historically moved both up and down as a result of market conditions?

A. Yes. As mentioned previously, the IRS contribution limits are largely based on the funded status of the plans. In the past ten years, NSTAR has contributed more than $850 million to its pension and PBOP plans. Annual contributions have ranged from $49 million to $110 million.

Q. How are these amounts accounted for?

A. The differences between the actual cash contributions to the plans and the amounts recognized in accordance with SFAS 87 and SFAS 106 are reflected on the Company's balance sheet as a net prepaid asset. As of December 31, 2002, NSTAR had a prepaid pension balance of $257 million on its books to reflect the cumulative amount that cash contributions have been greater than the cumulative net periodic pension cost. NSTAR also had a $53 million PBOP liability balance on its books to reflect the cumulative amount that net periodic PBOP cost has been greater than the contributions to the PBOP trusts.

Q. What is the outlook for the future concerning the level of funding required for the Company's pension and PBOP plans?

A. During 2003, NSTAR anticipates contributing $80 million to the pension plan and $38 million to the PBOP plan. Current projections have NSTAR making more than $200 million of contributions to the pension plan and more than $300 million to the PBOP plan from 2004 to 2013. These projections assume that investment results return to a more stable level and that interest rates increase from the current historically low levels. Should the actual experience differ from these assumptions, the contribution levels may be affected.

V. DESCRIPTION OF RATEMAKING FOR PENSION/PBOP PLANS

Q. In general, how has the Department approached the recovery of pension and PBOP costs in the past?

A. The fundamental objective of the Department's traditional cost of service ratemaking approach is to set rates prospectively based on the representative level of costs incurred during a test-year period. Because of the volatility involved with the SFAS 87 and SFAS 106 expense calculations, and the differences between those calculations and the calculation of the IRS tax-deductible contribution, the Department has faced a substantial challenge in determining the appropriate "representative" level of a company's annual pension and PBOP expenses for inclusion in rates. As a result, the Department has adopted differing ratemaking approaches depending on the circumstances of the case.

Q. Please describe the different ratemaking policies that the Department has applied to NSTAR in the past.

A. As with other utilities in the Commonwealth, the Department has accorded varied treatment to NSTAR's pension and PBOP plan expenses. For example, in one case, the Department allowed SFAS 87 amounts to be considered in allowing a reduction to NSTAR Gas' test year booked amounts. See Commonwealth Gas Company, D.P.U. 87-122 (1987), at 64 (request for Department approval of a post-test year adjustment to reflect a decrease to it test-year pension expense amount based on the effects of the recently effective SFAS 87 rules was granted with minor adjustments). In other cases, the Department has considered only the cash contribution amount when determining the appropriate amount for inclusion in the cost of service. In the case of Cambridge, the Department required that Cambridge's cash contribution be phased in over four years with a carrying charge allowed on the deferred balances. Cambridge Electric Light Company, D.P.U. 92-250 (1993)

Q. Please explain how NSTAR's pension cost is included in rates.

A. It should be noted that current pension and PBOP obligations are attributed to employees, a portion of whose time is capitalized and recovered in rates in future years. The actual proportion of capitalized labor depends on each year's capital program, but the number has typically been around 25 percent. For example, if the total pension cost is $100 and 25 percent is capitalized, $75 is the expense for the year and $25 increases the gross plant for the Company. Because the capital portion is recovered over future years through depreciation, the carrying charge for the capital portion is recovered in the carrying charge for the rate base.

Q. How was the amount of pension and PBOP cost in rates for Boston Edison determined from an historical perspective?

A. The amount allowed in rates for the period 1993 through 1995 was determined as a result of a settlement agreement between Boston Edison and the Attorney General, which was approved by the Department. Boston Edison Company, D.P.U. 92-92 (1992). Under the terms of the Settlement Agreement, pension expense was booked at the tax-deductible funded level through 1995. According to the Settlement Agreement, however, the difference between the tax-deductible amount and the SFAS 87 amount was deferred consistent with Boston Edison's test-year practice. D.P.U. 92-92, Settlement Agreement, at 10. The Settlement Agreement stated that PBOP contributions would be accounted for in accordance with the methodology set out by the Department in Massachusetts Electric Company, D.P.U. 92-78 (1992) (i.e., funding the tax deductible amount), to be funded over a five-year period.

The amount of pension and PBOP cost for the period 1996 through March 1998 was the 1995 cast-off rates from the D.P.U. 92-92 settlement. The amount for the period March 1998 through 2002 was the sum of the amount in distribution rates taken from the cost of service used to set the cast-off rates in Boston Edison's restructuring settlement agreement in D.T.E. 96-23. The amount in transmission rates is established based on the approved tariffs at the Federal Energy Regulatory Commission ("FERC")[1] and as included in retail rates in the annual reconciliation filing made with the Department.

[1] It should be noted, that FERC precedent permits carrying charges on prepaid pension expenses. *77 F.E.R.C. P63,017; 1996* Cities of Greenwood and Seneca, South Carolina v. Duke Power Company, Docket No. EL95-31-000, Initial Decision, November 27, 1996, Item 14.

Q. How was the amount of pension and PBOP cost in rates for Cambridge determined from an historical perspective?

A. The Department's most recent base rate decision for Cambridge was issued in 1993 in Cambridge Electric Light Company, D.P.U. 92-250 (1993). Cambridge sought an adjustment to its test-year PBOP expense to reflect, in rates, the maximum tax-deductible contribution amount when calculated in conformance with FAS 106. Cambridge proposed to fully fund its PBOP plan by this amount without a phase-in and include this amount in rates. However, the Department found that a four-year phase-in of the full tax deductible amount was necessary, and permitted Cambridge to defer the difference between the amount recovered in rates and the tax-deductible amount, plus carrying costs based on the allowed rate of return. Id., at 54. In addition, the pension amount proposed by Cambridge was not contested. Therefore, the amount allowed in rates for the period 1993 through March 1998 was the amount allowed in D.P.U. 92-250. The amount for the period March 1998 through 2002 was the sum of the amount in distribution rates from the cost of service used to set the unbundled rates in Cambridge's restructuring proceeding, D.T.E. 97-111. The amount in transmission rates is established based on the approved tariffs at the FERC and as included in retail rates in the annual reconciliation filing made with the Department.

Q. How was the amount of pension and PBOP cost in rates for Commonwealth determined from an historical perspective?

A. The Department's most recent base rate decision concerning Commonwealth was issued in 1991. Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80 Phase One (1991). Commonwealth's proposed pension expense in that case reflected an actuarial determination of pension costs made pursuant to SFAS 87. The Department denied Commonwealth's use of SFAS 87 amounts, instead requiring that Commonwealth be permitted to recover only the actual amount of test year cash contribution to the pension plan. Id., at 65-66. Therefore, the amount allowed in rates for the period 1993 through March 1998 was the amounts allowed in D.P.U. 90-331 for pension and the amount for PBOP was taken from the annual amount in the test year paid to retired employees. The amount for the period March 1998 through 2002 was the sum of the amount in distribution rates from the cost of service used to set the unbundled rates in Commonwealth's restructuring proceeding, D.T.E. 97-111. The amount in transmission rates is established based on the approved tariffs at the FERC and as included in retail rates in the annual reconciliation filing made with the Department.

Q. How was the amount of pension and PBOP cost in rates for NSTAR Gas determined from an historical perspective?

A. The Department's most recent base rate case for NSTAR Gas (then Commonwealth Gas Company) was issued in 1991. Commonwealth Gas

Company, D.P.U. 91-60 (1991). From that time, the amount allowed in rates for was from the D.P.U. 91-60 for pension and the amount for PBOP was from the annual amount in the test year paid to retired employees.

Q. What ratemaking policies have been applied historically by the Department to utilities' pension and PBOPs in Massachusetts?

A. Before the implementation of SFAS 87 and SFAS 106, electric and gas utilities in Massachusetts typically were permitted to include the test year pension and PBOP expense in rates. The annual net pension expense that was recorded on a company's books and the amount actually funded were commonly (although not always) the same. In December 1985, FASB issued SFAS 87, establishing new standards of financial accounting and reporting for an employer that offers pension benefits to its employees. As a result, the amount shown on a company's books for accounting purposes and the actual amount funded are less likely to be the same. Moreover, the IRS established its own rules for tax-deductible limits on company contributions to pension plans based on its interpretation of whether a particular plan was "overfunded." These changes caused the Department to reexamine its historical ratemaking approach to pension plan contributions.

Q. How did the Department's precedent change as a result of SFAS 87 and SFAS 106?

A. After SFAS 87, the Department began to examine the implications of the new accounting standard and its precedent has evolved ever since. The first case to address the issue was Western Massachusetts Electric Company, D.P.U. 87-260 (1988); see also Western Massachusetts Electric Company, D.P.U. 89-255, at 22 (1990). The Department disallowed the Company's pension expense in the cost of service because although the Company booked an amount for SFAS 87 pension expense in the test year, it did not fund the plan during the same period.

In Bay State Gas Company, D.P.U. 89-81, at 35 (1989), the Department allowed accrual-based expenditures for the company's PBOP employee benefits, finding that Bay State had satisfactorily established the annual expense that must be made in order to correct a situation of unfunded benefits, and that the record supported a finding that "prefunding" such obligations would result in net benefit to the company's customers.

In 1992, the Department articulated a different approach to the rate recovery of PBOPs in Massachusetts Electric Company, D.P.U. 92-78 (1992). The Department noted that the full SFAS 106 expense proposed by Massachusetts Electric is the single largest proposed adjustment in the rate case and that the extent of this SFAS 106 obligation "is subject to a significant degree of [actuarial] uncertainty." Id., at 80. The Department found that "some level" of PBOP obligation above the "pay-as-you-go" amount is necessary "to allocate PBOP expenses appropriately and cost-effectively between current and future ratepayers and between ratepayers and shareholders." Id., at 83:

> In reviewing the alternatives presented, the Department finds that funding the tax-deductible amount strikes the best current balance of these interests.

Id. However, in order to mitigate the revenue requirement impact, the Department required a four-year phase-in to the full tax-deductible amount, allowing carrying costs using the allowed rate of return on the deferred amounts.

In the case of Cambridge, however, the Department allowed Cambridge to defer any costs computed under SFAS 106 that were not included in cost of service for ratemaking purposes. Cambridge Electric Light Company et al, D.T.E. 99-90-C, at 85 (2000), citing Cambridge Electric Light Company/Commonwealth Electric Company/Commonwealth Gas Company, D.P.U. 92-172, Letter Order (November 10, 1992).

In Massachusetts Electric Company, D.P.U. 92-78, the company made a cash contribution to its pension plan in excess of the level of expenses based on SFAS 87. Id. at 46. Rather than allow the cash contribution amount, the Department granted the company's request that it be permitted to include in rates only the lower level of expense, as calculated by SFAS 87. According to the Department:

> [T]he Department accepts the Company's proposed adjustment to pension expense of $229,000. However, the Department does not endorse any specific methodology for the future. The intricacies of this issue warrant an investigation on a case-by-case basis.

Id. (emphasis added).

In Boston Gas Company, D.P.U. 93-60 (1993), the Department rejected the inclusion in base rates of Boston Gas' tax-deductible cash contribution amount concluding that it could not be considered a test-year contribution because the contribution related to the prior year's allowed tax-deductible contribution. Id. at 235. In Boston Gas Company, D.P.U. 96-50-C, at 42-43 (1997), the Department found that the average of the historical five-year pension contributions is the appropriate measure in determining the level of pension expense to be included in rates. Id. at 43. However, in Mass-American Water Company, D.P.U. 95-118, at 111 (1996), the Department based the company's allowable pension expense on a four-year average of actual cash contributions, rather than the five-year average allowed in D.P.U. 96-50-C.

In Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25 (2002), the company did not book any test year expense during the test year because the company's pension fund was over-funded relative to its future obligation. Fitchburg had not made a cash contribution to its pension plan since 1997. The Department concluded that "if a company does not make any pension contributions during the test year, the Department will not include any pension expense in the cost of service." Id. at 111.

The ratemaking treatment concerning SFAS 87 and SFAS 106 amounts has also varied significantly between post-divestiture pension expense recovery and prerestructuring/divestiture rate base recovery. For example, notwithstanding the ratemaking treatment accorded to SFAS 87 and SFAS 106 expense described above, the Department has approved fully reconcilable post-divestiture SFAS 87 and SFAS 106 amounts. Boston Edison Company's Restructuring Settlement Agreement provides that the total "post divestiture" SFAS 87 and SFAS 106 gains or losses recognized on Boston Edison's books "shall be reflected in distribution rates to customers <u>and shall neither be retained nor borne by [Boston Edison]</u>." (<u>i.e.</u>, fully reconcilable). Boston Edison Company Restructuring Settlement Agreement, at 8 ftnt.5, as approved by the Department in <u>Boston Edison Company</u>, D.P.U. 96-23 (1998) (emphasis added). <u>See also</u> Massachusetts Electric Company restructuring settlement agreement, as amended, <u>Massachusetts Electric Company</u>, D.P.U. 96-25-A (1997) (Department approves agreement with same provision to that approved in <u>Boston Edison Company</u>, D.P.U. 96-23)

VI. PROPOSED PENSION/PBOP ADJUSTMENT MECHANISM TARIFF

Q. What is the objective of the Company's proposal?

A. The Company's obligation to provide pension and PBOP benefits to employees is ultimately recoverable from customers as a cost of service. However, as discussed above, the Department's traditional ratemaking process generally allows for the recovery of costs incurred to provide service to customers based on the identification (and inclusion in rates) of a representative level of costs. The difficult task of determining the appropriate amount of pension and PBOP cost to be included in rates is greatly exacerbated as a result of circumstances in the financial markets, especially when taken in combination with the disparity between the annual IRS tax-deductible amount and the annual SFAS 87 and 106 cost. For example, even though the Company has made contributions well in excess of the level collected in rates over the past several years in order to maintain the funded status of the Plan, market changes have resulted in a significant prepaid amount, large unrecognized losses and an Additional Minimum Liability, which will lead to a large increase in the level of expenses booked in accordance with the requirements of SFAS 87 and SFAS 106 beginning in 2003.

In fact, the problems with treating the long-term funding pension and PBOP as a “normal” rate-case expense put NSTAR in the position of requesting the approved accounting ruling last year, in order to avoid large, detrimental financial impacts. This proposal is intended to establish an improved ratemaking approach for NSTAR to implement a reconciliation mechanism for pension and PBOP expenses that provides for a more timely way to recover such expenses. The proposal also accomplishes two major objectives. First, in light of the difficulty of identifying the representative level of costs to be included in rates, the Company’s proposed ratemaking mechanism would ensure that customers pay no more and no less than the amounts actually needed to provide pension and PBOP benefits to employees. Second, the mechanism would ensure that the financial health of the Company is not impaired as a result of the financial reporting and cash-flow issues that arise from the extreme volatility of pension and PBOP funding obligations.

Q. Please describe generally how the proposed pension/PBOP adjustment mechanism is designed to operate.

A. The pension/PBOP adjustment mechanism will permit a separate, annual rate adjustment for each distribution company of NSTAR. The mechanism is designed to reconcile the annual amounts booked by the Company in accordance with SFAS 87 and SFAS 106 with the annual pension/PBOP expense amount included in the Company's base rates. The use of this annual reconciliation mechanism will ensure that, over time, customers are paying no more and no less than the prudently incurred costs associated with providing pension and PBOP benefits to the Company's employees. The Company expects to file an annual adjustment factor for the following year each December 1st of the prior year (coincident with the reconciliation filings for the electric companies relating to transition charges, transmission charges, and Standard Offer and Default Service charges), for effect on January 1st of the coming year.

Q. What are the component parts that make up the calculation of the annual adjustment factor?

A. The annual adjustment factor is a surcharge or credit to base distribution rates that establishes a new level of recovery of pension/PBOP expense based on the most recent three-year average of actual cash contributions to the plans and the reconciliation of the difference between the amount included in rates and the expense required to be booked in accordance with the accounting requirements of SFAS 87 and SFAS 106. There are three major components to the calculation of the annual adjustment factor: (1) the three-year Average Differential Amount; (2) the Reconciliation Adjustment; and (3) Carrying Charges on Unamortized Reconciliation Deferral and the previous year's Average Pre-Paid Amounts (less deferred taxes). These three components are then added to the Past Period Reconciliation Amount and the sum is divided by the total forecasted number of kilowatt-hours ("kWh") or therms in the upcoming calendar year to determine the coming year's annual adjustment factor. The annual adjustment factor, which is expressed as a cents per kWh or therm charge, will be applied equally to all kilowatt-hours or therms sold by the Company. In some cases, it may be necessary, for rate design purposes, to convert the per-kWh charge to a demand charge collected on a per-kilowatt basis.

Q. Please explain the calculation of the three-year Average Differential Amount.

A. The three-year Average Differential Amount represents the difference between the expense amount of pension and PBOP currently included in the Company's base rates (i.e., the pension and PBOP amounts that were expensed in rates rather than capitalized) and the three-year average amount (2001 through 2003) funded by the Company for its pension and PBOP plans. As set forth in Exhibit NSTAR-JJJ-4, the aggregate amount of the Company's base rate pension and PBOP expense amount in 2003 is $37 million. The Company's three-year average cash contribution to its pension and PBOP plans is estimated to be $102 million for calendar years 2001 through 2003. Of that amount, approximately 25 percent is capitalized, and thus included in the Company's rate base. Accordingly, the portion of the actual cash contributions that would be expensed is 75 percent of the total, or $77 million. Thus, the aggregate Average Differential Amount component is estimated to be approximately $40 million for the Company. This amount will continue to be collected on an annual basis going forward until the Company establishes a new base rate amount for pension and PBOP expense.

Q. Please explain the Reconciliation Adjustment.

A. The Reconciliation Adjustment provides for the reconciliation and recovery through a rolling three-year amortization of the Reconciliation Deferral, which is the difference between the total amount of SFAS 87 and SFAS 106 expense included in the Company's rates and the amount of SFAS 87 and SFAS 106 expense that was booked. Each year, this difference may be either a positive or negative amount, depending on the amount that the Company is required to book in any year pursuant to the FASB rules to cover its ongoing responsibility to its employees. The difference is added to or subtracted from the unamortized balance of the deferral account and the total is amortized over a three-year period. The amortization amounts are added (or subtracted) to the annual adjustment factor. Amortization over a three-year period will allow the Company to recover the Reconciliation Adjustment over time, thereby having the effect of "smoothing" the amount of change in the annual adjustment factor from one year to the next. This resulting effect will benefit customers and will serve the Department's long-established ratemaking goal of rate continuity.

It should be noted that the first year of application of the Pension Adjustment Mechanism to customer bills will include, as a beginning balance to be amortized in the Unamortized Reconciliation Deferral factor of the tariffs, for Cambridge, $3.7 million in Department-approved deferred SFAS 106 expense (see Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993)); and, for Boston Edison, $4.2 million in Department-approved SFAS 87 deferred expense from Boston Edison Company, D.P.U. 92-92 (1993) (Department approved Settlement

Agreement that provides for deferral of difference between tax-deductible amount and SFAS 87 amount).

Q. Please explain the carrying charge on the Unamortized Reconciliation Deferral.

A. The annual adjustment formula includes carrying charge on the unamortized balances of each of the Reconciliation Deferrals. Because the level of expenses calculated in accordance with FASB requirements, must be "realized" each year, the delay in rate recovery requires the application of carrying charges to ensure that the Company and customers are compensated for the time value of money. The return will be based on the tax-effected weighted average cost of capital for each distribution company, as most recently applied by the Department. For the electric distribution companies, Boston Edison, Cambridge and Commonwealth, the tax-effected weighted average cost of capital applied by the Department on the fixed component of their transition charge (10.88 percent, 12.70 percent and 13.49 percent, respectively). For NSTAR Gas, the tax-effected, weighted average cost of capital used by the Department for NSTAR Gas' working capital component in the Cost of Gas Adjustment clause is 15.53 percent.

Q. How will the rate for the carrying charges be adjusted in the future?

A. The Company would adjust the carrying charge at the time of a general rate case, when the Department sets a new weighted average cost of capital.

Q. Please explain the carrying charges on the previous year's Prepaid Amounts.

A. The Company has made cash contributions to its pension and PBOP plans that greatly exceed the amounts that the Company has historically booked to its SFAS 87 and SFAS 106 costs. The balance of this prepaid contribution amount will decline over time as the Company's actual aggregate yearly contributions to the pension and PBOP plans are reduced relative to amounts booked pursuant to SFAS 87 and SFAS 106. In fact, as described above, the net prepayment amount is actually composed of a positive deferral for SFAS 87 and a liability for SFAS 106. Although the exact year cannot be identified with certainty, at some point in the future the balance of the prepaid contribution amount will be reduced to zero. Until that is accomplished, the carrying charge on net prepaid contribution amounts based on the Company's tax-effected, weighted average cost of capital should be applied to compensate the Company for the time value of its payments.

Q. Why is the Company requesting a carrying charge on the previous year's Pre-Paid Amount?

A. As indicated, the Company has made a significant cash contribution to its pension and PBOP plans that greatly exceed the amount otherwise required according to the SFAS 87 and SFAS 106 requirements. This prepayment was contributed at a time when the IRS rules permitted such a contribution on a tax-deductible basis, and when the Department encouraged electric and gas companies to make contributions to their plans equal to the full amount of their tax-deductible levels.

The receipt of a carrying charge by the Company on the significant Pre-Paid Amount is a reasonable regulatory response to the Company's efforts to maintain secure and fully funded pension and PBOP plans for its employees prior to the development of the Company's proposed Pension/PBOP Adjustment Mechanism. The prepayment of pension and PBOP obligations requires the use of Company funds, which means that those funds are not available to the Company for other purposes. In that regard, the pre-funding or prepayment of future pension costs is cash that has been provided from Company funds. Therefore, there is a cost associated with using these capital resources to pre-fund the Company's pension obligations in the same way that there is a cost associated with using such funds to support the Company's working capital requirements and investments in plant in service. The carrying charges that the Company is proposing to include in the reconciliation mechanism simply reflect the cost of money the Company is incurring for the capital used to pre-fund its obligation. It should also be noted that the carrying charges provide benefit customers when, as now the case with PBOP prepayment, there is a "negative" deferral. The symmetrical application of carrying charges, thus properly recognizes time-value of money for customers and the Company.

Q. Is the annual adjustment factor fully reconciling?

A. Yes. Each year, each of the distribution companies will file for a new adjustment factor for the next year. The filings will be made at the time the electric companies submit their annual transition charge reconciliation filing. The factor will compute each component, and the total recoverable amount will be converted into a unit charge by dividing by the projected kWh or therms for the upcoming year. Of course, it is not possible to know future sales levels with certainty because it is affected by customer demand, weather, the local economy and the level of new construction in the Company's service territories. Because the annual adjustment factor is applied to all sales, it may either over-collect or under-collect the computed pension and PBOP expense amounts. Accordingly, a Past Period Reconciliation Amount is included in the calculation of the upcoming annual adjustment factor to reconcile any over- and under-collections that will occur during the course of any particular calendar year. As is the case with other reconciliation mechanisms, this reconciliation will be based on a combination of actual and forecasted data for the year in which the filing is made and a final reconciliation when the data from a year are final. It is anticipated that the amount of this factor will be relatively small because of the Company's ability to forecast its load requirements with a high level of accuracy.

Q. Does this conclude your testimony?

A. Yes.